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DIRECTORATE OF INTELLIGENCE

Economic Reform in China

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Summary

The past year has been a watershed for China's ambitious economic reform program as proponents--backed by Deng Xiaoping--pushed through major policy directives for agriculture and industry. The new policies will reduce the scope of central planning while placing greater reliance on market signals to guide China's economy. The reforms will not transform China into a capitalist country, but they do represent a sharp break with orthodox Marxist economic practices and thus are controversial. Beijing has had difficulties, as it expected, when implementing reforms, but has moved quickly to control inflation and economic crimes that have arisen in the wake of new policies. Reformers now appear poised to implement key wage and price reforms later this year.

AGRICULTURAL REFORMS

Deng Xiaoping considers agricultural reform to be China's most important economic achievement, and the driving force for other reforms. Since 1978 Beijing has gradually dismantled the Maoist commune system in the countryside. The "household responsibility system," which gave peasant families effective control, but not ownership, over farmland was introduced in 1979, first in China's poorest areas and later throughout China. The responsibility system allowed peasants to lease land for a fixed period--now 15 years for most uses--and gave them leeway to manage the land as they wanted. Peasants, in return, had to meet production quotas but could sell

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above-quota output to the state at premium prices. To encourage greater production, in the spring of 1979 Beijing raised procurement prices of all major farm products.

Agricultural reforms were controversial when introduced, but success has overwhelmed the critics. From 1979 to 1983 the total value of agricultural production grew at an average annual rate of 8 percent, and record harvests the past two years have left China with a grain and cotton surplus.

In early 1985 Beijing signaled its intention to place even greater reliance on market forces to guide agricultural production. Instead of purchasing all grain produced--and paying a premium price for over-quota production--the state will sign production contracts with individual farmers for a specified quantity of grain. Both the contracted amount of grain and the purchase price will be less than previous levels. Peasants will be encouraged to sell surplus production on the open market, but the state will purchase excess grain if the free market price falls below a state-determined minimum price. Peasants growing grain on land ill-suited to grain production will be offered subsidies to raise livestock or grow cash crops. In addition, price controls on pork and vegetables are being lifted.

The new policies are designed to promote the development of a diversified agricultural sector and to encourage peasants to produce better quality products and make more efficient use of their land. Beijing also wants to reduce the growing surplus of grain caused by earlier agricultural reforms and to relieve the financial burden imposed by the previous commitment to purchase all over-quota production at premium prices.

INDUSTRIAL REFORMS

China's reform leaders frankly acknowledge that rigid central planning is responsible for much waste and inefficiency in their economy. Experiments with industrial reforms have been under way since 1979, but the Third Plenum of the 12th Party Congress in October 1984 placed the party's stamp of approval on a broad set of measures, which, taken together, are designed to improve industrial performance. The new policies will diminish the scope of central planning: only about 60 major products--such as steel, petroleum, and chemicals--will remain under mandatory state production quotas. Most goods will be produced under "guidance" plans that are set by the state but that are flexible enough to enable enterprises to adjust to changing market conditions. Some consumer items, many agricultural products, and the over-quota production of most goods will be traded in essentially unregulated markets.

Beijing plans to maintain macroeconomic stability while decreasing administrative controls by making greater use of economic levers such as interest rates, credit, and taxes. The success of industrial reform, therefore, largely depends on Beijing's ability to monitor developing economic problems and implement appropriate economic controls.

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Reform of Enterprise Management

A major goal of reform this year is to increase the authority of enterprise managers and reduce the control of party and government officials over economic decisionmaking in factories. Managers already have more leeway to develop production and marketing strategies, hire and fire workers, and set prices and wages. Managers are increasingly held accountable for enterprise profits or losses. Competition between enterprises is encouraged.

According to press reports, output has increased dramatically in some factories in which managers have been given enhanced decisionmaking authority. China, however, lacks the large numbers of well educated managers and technocrats that are needed to run autonomous enterprises. Managers often hesitate to use their newly acquired authority; many, for instance, have the right to fire unproductive workers but almost never do. Attempts to replace enterprise directors with younger, technically competent people are often hindered by party officials who are reluctant to relinquish their decisionmaking authority.

Price Reform

Beijing has begun to adjust domestic prices by instituting a three-tiered price structure. Prices of key products, such as coal and steel, will still be set by the state but at levels that better reflect relative scarcities in the economy. The prices of many other products, including most manufactures, will fluctuate in response to market conditions within bounds set by the state. Supply and demand alone will determine the prices of minor consumer goods--for instance, some clothing products, cosmetics, and vegetables--and over-quota production of industrial goods.

Beijing recognizes that price reform is crucial to the success of the whole economic reform effort. Prices now bear little relation to costs of production or relative market scarcities. Low prices for energy and other raw materials encourage wasteful production practices while high prices for some industrial goods promote gross overproduction. This irrational price structure makes it difficult for Beijing to determine accurately which enterprises should be closed. Without price reform, increased enterprise autonomy may even promote a less efficient allocation of resources.

Chinese leaders are now moving to establish gradually a more rational price structure. This year they plan to raise short-distance railroad rates, widen price differentials for similar products of differing quality, and increase the role of the market in determining prices of agricultural products. Beijing is committed to maintaining the real income of workers--most likely with wage hikes--and will probably continue to provide subsidies to cover enterprise losses during the adjustment period.

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Wage Reform

This summer China plans to implement a wage system that will link workers' wages and bonuses with the economic results of their enterprises. The total wage funds for an industrial enterprise will float upward or downward based on the amount of profits earned and the amount of taxes delivered to the state. Individual wages, once guaranteed regardless of output or qualifications, will better reflect job performance. More productive workers will receive higher pay, and wages will also reflect seniority, the cost of living, and skills in demand.

Reformers recognize that egalitarianism, by stifling individual initiative, results in collective poverty. Many Chinese factories that have experimented with a performance-based wage system have realized marked gains in productivity; however, force of habit and ideology die hard, and factory managers often continue to distribute bonuses in an egalitarian manner even when given the authority to offer differential rewards.

Tax Reform

During the past two years, Beijing has eliminated the profit delivery system under which enterprises were required to turn over all profits to the state. Enterprises now pay a share of their profits in taxes and enterprise managers have considerable leeway to use after-tax profits for worker bonuses or investment.

Beijing anticipated an immediate loss of revenue as a result of adopting the tax program. Recent press accounts of confusion, delays in remitting taxes, and enterprises illegally inflating costs to reduce tax liabilities bear out Beijing's concerns. Reform leaders, however, hope these short-term losses will be outweighed by a long-term, supply-side response as the incentives for increased production and efficient internally financed investment provided by the new system take effect.

Bank Reform

Reform leaders intend to transform China's banks from fund disbursing organs to independent banks--responsible for their own profits and losses--that operate under broad state supervision. Beijing has decreased the amount of funds that banks must deposit with the People's Bank of China (China's central bank), while granting individual banks increased discretion in distributing their remaining funds. Some banks now may adjust loan rates within a 20-percent range of the state-determined rates. Beijing is also encouraging the development of private credit institutions in the countryside as a supplement to the rural banking system. These institutions--often in the form of credit unions or joint stock operations--pool peasant earnings for use as local investment funds.

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Historically, banks served as a conduit for the Ministry of Finance, and loans were made to meet central plans without regard to the borrower's financial status or the expected rate of return of the project. Interest charges were held low, if assessed at all, and repayment was seldom enforced. Beijing hopes that allocation of investment funds will be improved when profit-seeking banks carefully screen prospective borrowers and when enterprises are forced to bear the costs of financial capital.

Thus far, banking reform has met with mixed results. Beijing claims the trial use of loans for capital construction projects has reduced construction periods and sped up turnover of working funds. Bank competition for borrowers, however, has resulted in the issuance of inadequately secured loans and the slashing of interest rates to unprofitably low levels. There is also evidence that local pressures, not economic factors, continue to determine the direction of loans, and some banks still have difficulties with enterprises that will not adhere to the terms of the loan.

Foreign Investment Reforms

In 1979 Beijing established three special economic zones--later adding a fourth--to encourage investment in China. Foreign firms that establish joint venture production in the special economic zones are offered favorable tax rates, lower tariffs on factory imports, and relative freedom in controlling operations--including hiring of local workers. Within the last year, Beijing gave 15 coastal cities the right to offer foreign investors similar concessions and announced its intention to expand the program to large sections of China's coast.

Foreign firms engaged in joint venture production may now sell their output within China as long as the venture's foreign exchange expenditures and receipts are balanced. Beijing also has allowed some foreign companies--such as 3M, Sanyo, and others--to establish wholly owned factories in China.

Foreign Trade Reforms

Beijing is reducing central control over foreign trade. City and provincial governments have greater authority to deal with foreign firms, and Chinese foreign trade enterprises can now operate as commissioned agents for manufacturers and importers of most products. Some of China's key state enterprises have independent authority to sign contracts for technological transformation projects, joint ventures, and compensation trade operations.

Reformers want to increase the stake that Chinese enterprises have in the trade process to enhance the timeliness and quality of imports and exports. Beijing is probably wary of foreign trade decentralization, however, since similar efforts in the early 1980s sparked cutthroat competition among ministries and provincial foreign trade organizations that caused a sharp deterioration in China's terms of trade.

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PROBLEMS ACCOMPANYING REFORM

Problems have arisen quickly for China's reform leaders since the October industrial reforms. Large increases in the money supply and in personal income and strong industrial demand for raw materials have caused a surge in prices during the past six months. Recent Chinese press reports indicate that the leadership is particularly concerned with inflation, the 1984 budget deficit that was almost twice as large as expected, and a sharp increase in price gouging, smuggling, and fraud. Although Beijing anticipated dislocations in the early stages of industrial reform, it probably has been surprised at the extent to which local officials and enterprise managers have taken advantage of loose reform guidelines to make windfall profits.

The emergence of these problems appears to have intensified debate within the leadership about the direction and pace of economic reforms, and conservative leaders have become more vocal in expressing practical and ideological concerns about the new policies. Reform leaders, however, have maintained the upper hand and moved quickly to tighten supervision of bank credit and worker bonuses and to crack down on economic crimes. Economic reform policies remain on track and Beijing seems poised to implement key wage and price reforms, albeit cautiously, later this year.

IS CHINA TURNING CAPITALIST?

Although a distinct departure from orthodox central planning, the recent reforms will not transform China into a capitalist economy. The state will continue to own the means of production; will still have direct control over output, pricing, and distribution of key products; will continue to limit labor mobility; and will continue to make major investment decisions. The state will also retain the right to appoint or remove enterprise managers and shut down inefficient enterprises. Entrepreneurs have been allowed to establish small privately run enterprises such as repair shops, restaurants, and tailor shops, but these activities involve less than 3 percent of the total labor force.

China's leaders are committed to retaining the essential socialist nature of their economy and are very sensitive to charges that they are introducing capitalist reforms. We believe opponents of reform have used Western press depiction of the reforms as "capitalist" to attack the program.

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